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FINANCIAL SERVICES

Consultants & Actuaries

THE GUARDIANS FUND: ISSUES AND OPTIONS PAPER

Draft for Discussion

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INDEX

1.	Introduction	Pg 3
2.	Legal Nature of Guardians Fund	4
3.	Corporate Governance	7
4.	Investments	13
5.	Administration	20
6.	Financial Management	23
7.	Education/ Communication/ Image	28
8.	Liability & Exposure	30
9.	Conclusion	34



1. INTRODUCTION

Alexander Forbes ('AF') was requested to critically review the existing management of the funds, held in trust for beneficiaries, by the Department of Justice ('DOJ') through the Guardian's Fund ('GF') in the current legislative environment.

In this 'Issues and Options Paper, we have synthesised the key results of our review on the 'Management of Monies in Trust'.

The issues identified include:

- Identifying a corporate governance structure;
- Identifying suitable authorities delegation;
- The administrative efficacy of the GF;
- Possible education and communication;
- Financial management and solvency of the GF;
- The complaints procedures;
- The decision making process and delegation;
- Conflicts of interest;
- Legal compliance;
- Investment matters; and
- Day to day operational management.

We have prepared our report on the premise that the GF is a quasi trust entity and deferred to applicable trust law principles. Our premise is based on the independent legal opinion obtained by the DOJ. Our own research supports this finding.

We begin by briefly summarising the legal opinion and our research findings on the nature of the GF and an analysis of the corporate governance landscape in South Africa and internationally and its pervasive impact on all entities including the GF.

The investment component of the report provides an introduction to the issues to be considered when setting an investment policy and providing appropriate mandates to the Public Investment Corporation (PIC). A more comprehensive report along with detailed recommendations will be provided thereafter.



2. LEGAL NATURE OF THE GUARDIAN'S FUND

The Guardian's Fund was established in terms of section 91 of the Administration of Estates Act 24 of 1913. This Act was replaced by the Administration of Estates Act 66 of 1965 ("Administration of Estates Act") and reference to the Guardian's Fund is made in Chapter V of the Administration of Estates Act, which covers sections 86 to 93 of that Act.

Whilst the Guardian's Fund is established in terms of statute, the statute in question, namely the Administration of Estates Act, does not specifically state that the GF is a trust. Hence uncertainty exists regarding the exact legal nature of the GF.

The Trust Property Control Act 57 of 1988 ('TPCA') imposes a statutory definition of a trust fund that is not applicable to the GF, because, as far as we are aware, the GF is not registered in terms of that legislation.

A legal opinion received from the office of the Chief State Law Advisor deals with the relationship between the Director-General (Department of Justice and Constitutional Development), the Chief Master and the Chief Financial Officer ("CFO") and suggests that as the GF is required to pay, at some future point, moneys to persons so entitled, it is for the purposes of the Public Finance Management Act 1 of 1999 (the PFMA) holding such moneys in trust. (1)

Further, that as the GF keeps money for a certain period until the person entitled thereto claims the money it keeps such money in 'trust'. Deferring to a legal reference source, the conclusion drawn is that 'In the wide sense a trust exists when property is to be held or administered by one person on behalf of another, or for some purpose other than his own benefit...' The opinion concludes that 'one could venture to say that it may qualify as a trust fund if looked at in that context.'

It is thus submitted that the Guardians Fund falls outside the statutory definition of a trust in South Africa, but appears to fall within a wider, more general sense of the ambit of a trust. We shall explore hereunder more carefully whether the Guardians Fund does possess the essential features of a trust.

(1) Section 13 of the PFMA requires that all money received by the national government be paid into the National Revenue Fund excepting for money received by a 'national department in trust for a specific person or category of persons or for a specific purpose....'



A trust is a legal institution in which a person, the trustee, subject to public supervision, holds or administers property separately from his or her own, for the benefit of another person or persons. (2)

A trust cannot exist without trustees, as it needs trustees to administer it. (3) In the case of the GF, it has Masters who administer the GF in each province. The Master receives monies on behalf of another (section 86), the Master pays out monies upon application of a person entitled to receive money (section 89 – 90A) and the Master administers the trust monies (section 91) by performing administrative tasks. These duties could be said to be the duties of a trustee and hence the GF shares these characteristics with trusts. We presume therefore that this would extend to include duties that would include, but are not limited to the following:

- accounting and administrative functions,
- asset management,
- declaration of interest rate,
- solvency assessment, etc

Trusts may be established by statute and thus it would be possible for the Government to form a trust through a mechanism such as the Administration of Estates Act (Honore page 118). For a valid trust to be created, the

- (a) founder must intend to create one;
- (b) founder's intention must be expressed in a mode appropriate to create an obligation;
- (c) trust property must be defined with reasonable certainty;
- (d) trust object must be defined with reasonable certainty;
- (e) trust object must be lawful.

An intention to create a trust, however clearly worded, is not enough unless established in some form, including through statute. Chapter V of the Administration of Estates Act clearly sets out Government's intention to establish the GF. Further, this legislation does create an obligation on the Master to receive, administer and pay out the monies held in the GF. It should be noted that the statute does not confer juristic personality on the GF.

The property to be held in trust must be defined with reasonable certainty. The Administration of Estates Act provides in section 86(1) what moneys shall be paid into the GF, including money which is "accepted in trust for any known or unknown person". It is submitted that the legislation does make it clear as to what amounts are required to be paid into the Guardian's Fund.

(2) T Honoré & E Cameron. *Honore's South African Law of Trusts*, Fourth Edition, Juta & Co, 1992, ('Honore').

(3) Honoré p 3



The object of the trust must be clear. The Administration of Estates Act sets out the persons for whose benefit the money is being held. However, the GF also holds money for unknown persons and thus it is not always clear who the object of the GF is. In particular, what happens if the benefit for an unknown person becomes unclaimed.

The trust object must be lawful and cannot promote unfair discrimination. There is nothing Chapter V of the Administration of Estate Act that suggests that there is any unlawful purpose or object in the formation of the GF.

The following extract from Honoré is interesting:

“In the wide sense a trust exists whenever someone is bound to hold or administer property on behalf of another or for some impersonal object and not for his or her own benefit. Such a person has at the minimum a duty to keep the property administered separate from personal property and to avoid a conflict of interest with the beneficiary or the trust object. In this wide sense, a “trustee” is any person so holding or administering property.”

It is submitted that on the basis of the above wide definition of trust and in considering the various characteristics of a trust, it can be said that the Guardians Fund is a trust in the wide sense.

Issues

- The legal nature of the GF remains ambiguous
- The founding legislation does not confer juristic personality on the Guardians Fund.

Options

1. Accept that GF is a quasi trust and prepare a governance framework using existing common law and prevailing corporate governance guidelines;
2. Lobby for amending legislation to establish the GF as a legal entity with mechanisms for governance incorporated into the legislation. This need not negate the provisions of section 90, providing that benefits not claimed after 30 years are forfeited to the state.



3. CORPORATE GOVERNANCE

“The 19th century saw the foundations being laid for modern corporations: this was the century of the entrepreneur. The 20th century became the century of management: the phenomenal growth in management theories, management consultants and management teaching (and management gurus) all reflected this pre-occupation. As the focus swings to the legitimacy and the effectiveness of the wielding of power over corporate entities worldwide, the 21st century promises to be the century of governance.” – King Report on Corporate Governance for South Africa 2002, Institute of Directors, King Committee on Corporate Governance, March 2002 (“King 2”)

“...A culture of governance would develop in which the trustees would treat their responsibilities very much like the job of running a company. They would think consciously about their skills, individually and collectively, and the structures and processes which would best ensure that they carried out the investment element of their role effectively. They would develop plans as a framework for their future activity”. – Paul Myners, Institutional Investment in the United Kingdom: A Review, 2001 (“Myners Review”) and the subsequent “Review of Progress”, 2004.

Governance has become an integral part of our lives in the 21st century, a logical extension of the fact that organizations and the environment in which we operate have become extremely complex. As corporate governance standards have increased significantly all over the world, so the governance standards that apply to trust funds in South Africa must follow suit.

Corporate governance was institutionalized when Mervyn King published the *King Report on Corporate Governance* (King) in November 1994. Whilst it took a long time for the principles of King to be accepted by corporate South Africa, by the time King 2 was published in 2002, the main principles advocated by King and King 2 had been embraced in South Africa.

King 2 provides seven characteristics of good governance that apply equally to fund governance. The principles that follow speak to a culture of governance rather than compliance:

- Discipline
- Transparency
- Independence
- Accountability
- Responsibility
- Fairness
- Social Responsibility

Discipline

Governance is integral to effective management of the GF and DOJ/ Master (hereafter referred to as ‘Management’) will need to embrace what is universally recognized to be ethical and proper behaviour. Whilst the TPCA and common law in South Africa require trustees to act in an appropriate manner, the principle of discipline calls for trustees to embrace the principles of good governance. Discipline is about a culture of governance rather than compliance.



Transparency

Transparency deals with the ease with which an outsider can assess trustees' actions. Trustee actions must be able to stand up to scrutiny from outsiders. A vital part of transparency is ensuring that the way in which the fund communicates with stakeholders is candid, accurate and timely.

Independence

Independence deals with the extent to which mechanisms have been put in place to manage or mitigate conflicts or potential conflicts of interest. These mechanisms should extend to the board, all internal processes, sub committees, and service providers appointed.

Accountability

Management is responsible for all decisions to manage the GF and must be accountable for its decisions. This means that management must ensure that processes are put in place to provide an opportunity for all stakeholders to query and assess their actions. Accountability speaks to the manner in which management communicates with all stakeholders. Regular appropriate communication is key to good governance.

Responsibility

Management must be accountable for its actions. Where necessary, it must correct any incorrect actions and deal swiftly and appropriately with any mismanagement.

Fairness

There may be conflicting interests between different stakeholders of the fund. In these circumstances, management must take account of the interest of all stakeholders and deal with issues in a manner which is equitable to each stakeholder.

Social Responsibility

King 2 states that a well managed company will be aware of and respond to social issues and place a high priority on ethical standards. For management this would include the timeous distribution of benefits to beneficiaries who are in need.



Why has governance become such a “hot” issue?

Recent improprieties in accounting practices and the downfall of large companies have increased the focus on good corporate governance. King 2 has encapsulated the significance of good corporate governance practices and advocates the adoption of an inclusive and integrated approach whereby all stakeholders are to be considered. The Report’s ultimate objective is to achieve “the triple bottom line” – better economic, social and environmental best practice in the market place, which should translate into improved long-term performance from companies.

Investors are increasingly making their presence felt by demanding better governance standards from companies in which they may potentially invest. The proposed “inclusive approach” to corporate governance focuses on issues which reflect the needs of all shareholders.

The King Report also made the following recommendations with regard to risk management from a company perspective, but may equally apply to the GF.

- Management should accept responsibility for the total process of risk management, as well as forming its own opinion on the effectiveness of the process;
- Management should set the risk strategy. These policies must be clearly communicated to all employees to ensure that the risk strategy is incorporated into the language and culture of the GF;
- Management should make use of generally recognised risk management to maintain a sound system of risk management and internal control to:
 1. safeguard stakeholders’ investments;
 2. support objectives and sustainability; and
 3. behave responsibly towards all stakeholders having a legitimate interest in the GF.

Management have a duty to act with due care, diligence and in good faith to the fund and to act in the best interests of the fund. Management have to exercise a higher degree of care and diligence in managing the affairs of the fund than they would in managing their own affairs.

It is vital that the Management act impartially and take all reasonable steps to ensure that the interests of all beneficiaries are protected at all times. Management’s fiduciary duties have their basis in the common law. However, certain duties have been codified in the Financial Institutions (Protection of Funds) Act and could be “borrowed” by the GF. (The Financial Institutions Act is not directly applicable).

The purpose of the Financial Institutions (Protection of Funds) Act is to deal with the investment, safe custody and administration of assets held by financial institutions. This Act highlights the high standard of care expected by those persons who manage the assets of a third party. In other words, there is a duty of good faith owed by Management in the course of managing the investments of the fund.



Good governance is becoming more important in the light of litigation and legislation surrounding this matter. The issue of responsible governance needs to be carefully considered by Management.

Is King 2 relevant for the Guardians Fund?

King 2 is mainly concerned with the good governance of companies, financial and insurance institutions. The intention being that these entities would use the principles and self regulate by developing their own governance strategies.

However, many of the principles, recommendations and suggested actions in the Code may be applied beneficially to the GF. One of the principles in King 2 that is directly applicable to the GF is in dealing with relations with stakeholders. In the recommendations concerning shareowner activism King 2 states that “Institutional investors should be more transparent in their dealings with institutions and should be encouraged to demand the highest governance standards”.

King 2 states further that:

“The absence of shareowner activism in South Africa seriously undermines good levels of managerial compliance. Institutional investors and pension funds for the most part remain passive despite some very obvious instances of poor or undesirable corporate governance practices by South African companies. A moderate level of activism has recently emerged however”.

King 2 includes a *code of corporate practices and conduct* as well as a number of recommendations for action and statutory amendments relating to, *inter alia*, the following topics:

1. Role and function of Management;
2. auditing and accounting standards and practices;
3. internal audit: the role of the internal auditor and the scope of the function;
4. the meaning of and importance of risk management and where the responsibility lies;
5. the corporate responsibility in respect of non-financial matters (e.g. the environment); and
6. how to ensure compliance and enforcement of governance principles.

What was the Myners Review?

In 2000, the UK government asked Paul Myners to carry out a wide-ranging investigation into the UK investment industry. The Government’s chief concern was that there might be factors unduly distorting investment decisions, resulting in too much concentration on quoted equities and gilts. (Interestingly the same observation could be made in South Africa.)

Significant considerations in the Review were to understand:

1. who is taking the investment decisions;
2. what the incentives are; and



3. what skills and knowledge they bring to their roles.

What key issues did the Myners Review focus on?

The following is a direct extract from the Myners Review

Principles:

In addition, the review sets out a short series of principles which it believes codify best practice for pension fund decision-making. Some of the main points are:

- Decisions should be taken only by persons or organisations with the right skills, information and resources needed to take them effectively.
- Management should set out an overall investment objective for the fund, in terms which relate directly to the circumstances of the fund and not to some other objective such as the performance of other pension funds.
- The attention devoted to asset allocation decisions should fully reflect the contribution they can make to achieve the fund's investment objective.
- Decision-makers should consider a full range of investment opportunities across all major asset classes, including private equity.
- The fund should be prepared to pay sufficient fees for actuarial and investment advice to attract a broad range of kinds of potential providers.
- Management should give fund managers an explicit written mandate setting out the agreement between them on issues such as the investment objective, and a clear timescale for measurement and evaluation.
- In consultation with their investment manager, funds should explicitly consider whether the index benchmarks that they have selected are appropriate. Where they believe active management to have the potential to achieve higher returns, they should set both targets and risk controls that reflect this, allowing sufficient freedom for genuinely active management to occur.
- Management should arrange to measure the performance of the fund and the effectiveness of their own decision making, and formally to assess the performance and decision-making delegated to advisers and managers.

These principles might appear basic, but the review believes that they call for considerable change in fund practice.

Is there guidance from the Retirement Funds Industry?

In reviewing the objectives of the GF it became apparent that the requirements of the GF were not dissimilar to those of a retirement fund. This was particularly true of the governance requirements.

The Financial Services Board (regulator of the retirement funds industry) recently released a circular (PF 130, for adoption by the industry, in which it attempts to clarify the fiduciary duties of trustees. The Code has as its source both the legislative duties contained in the Pension Funds Act and the Financial Institutions (Protection of Funds) Act, and the well-developed common law duties of persons in positions of trust. The circular sets out the twelve principles that can be said to constitute the fiduciary duties of



a trustee, and discuss how these elements may have application for the management board of a retirement fund.

The 12 principles are split into three sections as follows:

Governance by the Board

Principle 1 – Roles, Responsibilities and Accountabilities of the Board/the Governance Structure

Principle 2 – Composition and Competency of the Board and delegation through the use of Sub-Committees

Principle 3 – Board Orientation and Education

Principle 4 – Board Assessment and Breach of Code of Conduct

Governance by the Board of the Operations of the Fund

Principle 5 – Internal Controls/Governance Mechanisms

Principle 6 – Expert Advisors

Principle 7 – Risk Management

Principle 8 – The Investment Performance of the Fund Assets

Management of Stakeholder Relationships

Principle 9 – Communication and Access to Information

Principle 10 – Members and Beneficiaries (protection of rights)

Principle 11 – Employer and Sponsor

Principle 12 – Regulatory Authorities/ Effective Supervision

Issues

1. No management framework/rules/trust deed exist to provide any guidance to management in respect of the governance of the GF;
2. Prevailing Corporate Governance recommendations should be more fully embraced and adopted by management.

Options

1. In the absence of legislation, draft a trust deed/set of rules in the form of a circular to establish a uniform approach in managing the GF.
2. Develop a governance framework to be adopted by management. This should include:
 - A code of conduct;
 - Risk Management Policy;
 - Investment Strategy Policy
 - Communication Policy
 - Performance Appraisal of Management



4. INVESTMENTS

As discussed above, throughout the world, there has been increased focus on the way entities such as companies and retirement fund organisations are run. Equally, the effectiveness of Boards of Directors and Boards of Trustees is being more closely (and more frequently) inspected.

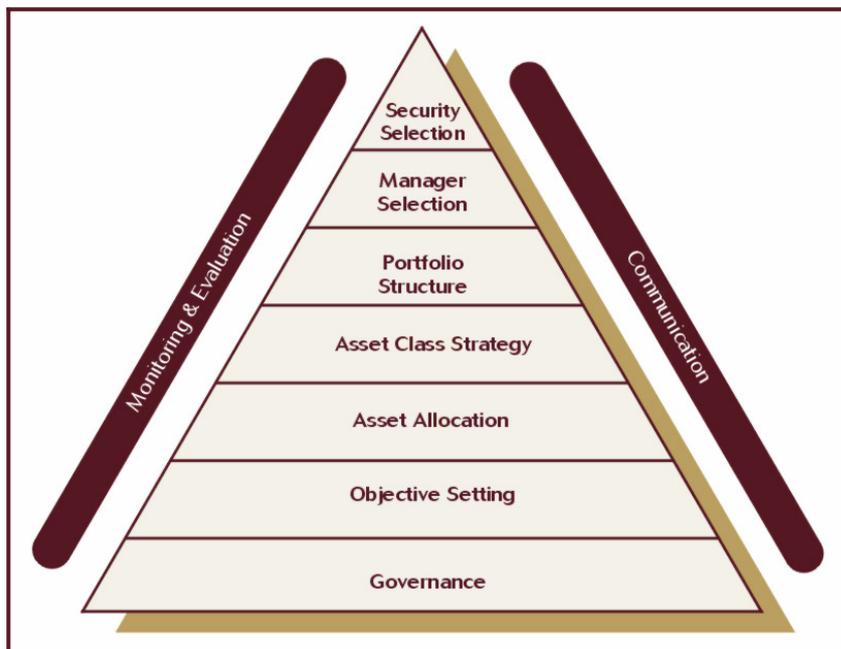
In the corporate context, there was the Cadbury report in the UK, the King Report in SA and a number of questions have been asked in light of corporate failures both internationally (Enron) and locally (Health and Racquet Club, Regal Bank, etc). As a result, the conduct of company directors is being questioned and reviewed on a regular basis.

A major outcome of this focus on corporate governance and corporate effectiveness has been a concentration on risk management and internal control.

Having reviewed these corporate governance principles, global best investment practice as well as overseas investigations into retirement funds investment management; Alexander Forbes has developed an Investment Risk Management Plan.

Investment Risk Management Framework

The framework can be illustrated as follows:



The illustration above is meant to be a construction similar to a pyramid. Each layer builds on another. A simple example is that without the correct objective, one is likely to be in the wrong type of portfolio, in which case manager selection cannot really add value. However, if one has the correct objective, one can incrementally add value by setting an appropriate asset allocation and ultimately, by selecting the right asset managers.



Governance

The base of the pyramid is “Governance”; essentially this level is analogous to the foundations of a building. A building with poor foundations will ultimately collapse.

Governance focuses on ensuring that the Fund runs properly and aims to remove the risk of total failure of an investment approach.

At this level, the following issues will be addressed:

- Conflicts of interest;
- Socially responsible investments;
- Principles relating to shareholder activism;
- Termination conditions;
- Credit exposure risk;
- Strategic investments;
- Disclosure of costs;
- Ethical investing;
- Organisational risk;
- Liquidity risk etc.

Management will focus not only on preparing policies on the above, but also ensuring that once these principles have been set out, all investments need to be evaluated against these criteria before any investment can be considered.

However, probably the **most** important aspect of the governance phase is the decision-making structure. It is absolutely essential that roles, responsibilities and decision-making authorities are clearly assigned.

When Management consider exactly what responsibilities they can accept and what they should delegate, they must be realistic about the time they have available. In many cases, it will be more appropriate to delegate decision-making authority to a group that has the appropriate time and skill rather than the Trustees trying to retain that authority themselves.

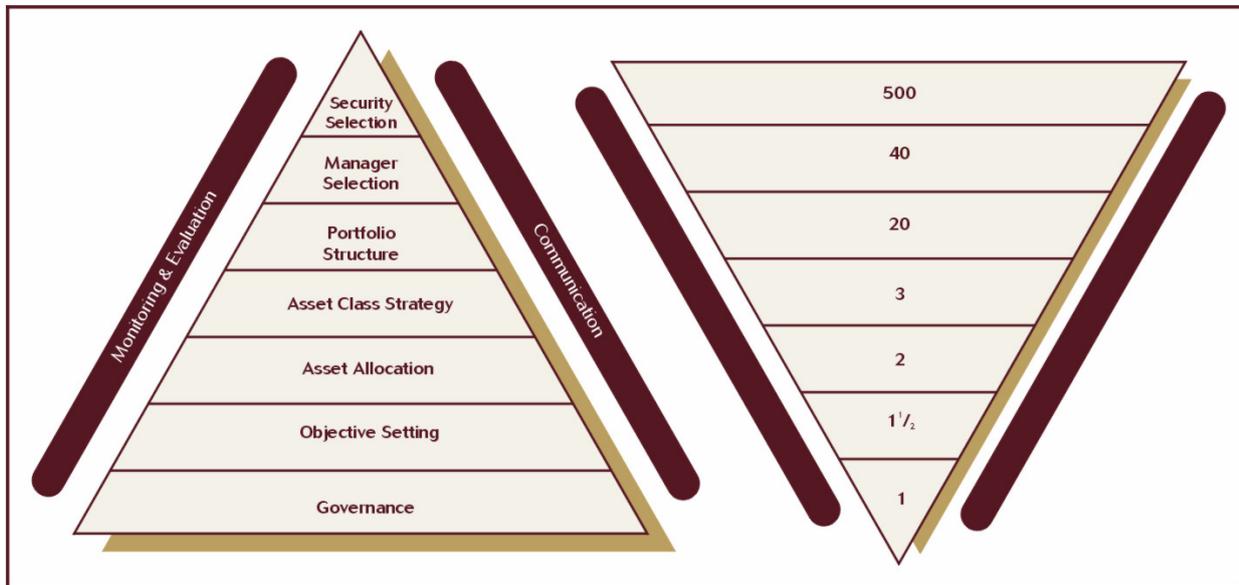
The pyramid on the left sets out the components of the risk management plan. The intention is that the size of the slice indicates the value-added at each level, i.e. Objective-Setting adds more value than Manager Selection. Similarly Asset Allocation adds more value than Security Selection.

The pyramid on the right indicates Management’s time spent in completing each level (the numbers are an illustrative indication of time spent {hours} per annum on an ongoing basis - admittedly the initial process may be more time-consuming).

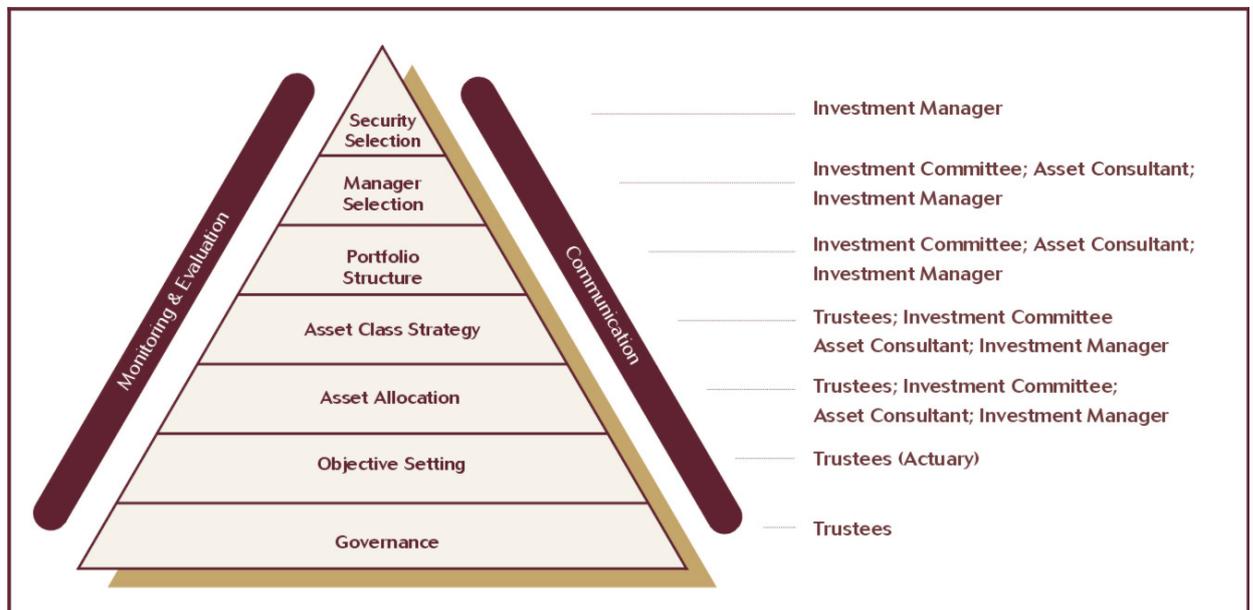
Communication and Monitoring & Evaluation, have not been specifically allocated times but these two components are addressed once the base strategy has been formulated. However, similar principles apply in that Management need to manage the *Value add – Time spent* ratio when assigning the Monitoring & Evaluation and Communication responsibilities.



Alexander Forbes urges Management to realistically assess how much time they can spend on investments, and then apply those hours to the areas in which greatest value can be added. Management can then consider to whom the other functions can be delegated.



The diagram below sets out some scenarios regarding the allocation of the relative roles and responsibilities between the various participants in the Investment Risk Management Plan.



The governance level of an investment strategy is frequently ignored. Yet it is at the governance level that the risk of total failure of an investment approach can occur.

Having addressed the various governance principles, and having clearly defined a framework within which the roles, responsibilities and decision-making authorities are set out, the “foundations” of an Investment Risk Management Plan are in place.

Management and their delegates can now proceed to the more fundamental (and exciting) task of establishing the investment strategy. **The greatest risk of total failure of an investment approach is at the Governance level.**

So, having completed the governance framework, what are the balance of the steps involved in formulating the Investment Risk Management Plan?

Objective Setting

"The indispensable first step to getting the things you want out of life is this: decide what you want."

- Ben Stein



This should be obvious but with many investment strategies, clear objectives have not been set. Often the objective will be to outperform other funds, but when questioned, Management may not have any idea why that is an appropriate or relevant objective. Equally important is that the strategy adopted needs to be a balance of often competing objectives, particularly where parties involved in the fund have competing interests.

When setting the investment objective one needs to understand and establish the objectives of the various different stakeholders. This is not simple, since often the stakeholders will not have considered what their objectives should be, (although they will soon tell you when things go wrong).

The key stakeholders are:

- beneficiaries;
- the Master;
- National Treasury;
- Department of Justice.

When discussing objectives, it is important to also consider the role played by peer-group benchmarks/performance surveys. The Myners Review in the UK strongly criticised the use of peer group benchmarks/performance surveys as overall objectives, since such objectives have no relationship to the fund's liabilities. However, since performance surveys are so widely publicised, particularly in the press, they cannot be totally ignored.

In general, peer group comparisons should not be a primary objective of the fund, but they may assist when setting benchmarks for some of the underlying portfolios. Nevertheless it is important for Trustees, together with their Consultants, to proactively consider the extent to which the performance of their overall strategy may diverge from the performance of the "average retirement fund" (when compared by the press or by members)."

A number of other issues will need to be considered before one can model the above objectives. These would include:



- The way the liability valuation basis will move in line with the market position of the assets;
- Future rules regarding investment return distribution;
- Solvency position.

Given the conflict between the objectives, it may not be possible to finalise the objectives at this stage. One sometimes will need to commence the asset modelling process (part of the Asset Allocation phase) before being able to identify the Objectives and Asset Allocation that create the ideal compromise.

Asset Allocation

In the asset allocation phase, this is the process of:

- (i) Deciding what broad asset classes the Fund will invest in and in what proportions, in order to achieve Fund objectives, and
- (ii) Deciding the major sectors in which to invest within each asset class and the standard proportion to be invested in each Sector.

In the asset allocation phase, one will model alternative investment strategies. In the most sophisticated cases, an asset-liability modelling exercise will be undertaken. This complex process will model how the Fund's assets and liabilities are expected to move in future, based on different asset allocations. This will enable Management to understand the range of possible outcomes, and hence, appreciate the risk of various strategies not achieving the identified objectives.

Asset-liability modelling is a complex, time-consuming and costly (not costly when one considers the value it adds) process. As a result, not all funds will have the resources to conduct such an exercise. If an asset-liability exercise is not undertaken, then such funds will rely on judgement and an understanding of the variability of asset classes to select an optimal asset allocation strategy.

When asset modelling, it is important to bear in mind that the performance of asset classes has limited predictability in the short run. It is only over the longer term (probably at least ten years) that the performance of the major asset classes is reasonably predictable. Part of this modelling process will focus on the correlations between asset classes, so one can appreciate how the volatility of a portfolio will reduce when asset classes are combined together.

Asset modelling focuses on the performance of asset classes, but the modelling tools can be extended to model other portfolios such as guaranteed funds, absolute return funds and structured products.

Technically, if one defines the objectives, and the consequent risks clearly, one can calculate optional portfolio mixes.



Asset Class Strategy

Having decided what the broad asset allocation of the various portfolios should be, the detail of the recommended strategy will be expanded. In the first case, one will consider whether there is any merit in replacing any of the modelled asset classes with additional asset classes, such as hedged equity, property or private equity. These additional asset classes are difficult to model reliably and hence, should be introduced via a subjective assessment (as opposed to an objective, quantitative assessment that was used when determining the overall asset allocation).

The subjective assessment will take into account considerations such as liquidity and the materiality of potential impact versus administrative costs (including demands on Trustees time). Once the asset allocation of the various portfolios has been agreed, the strategy within each asset class should be agreed upon. This would involve setting out the Fund's preference with regard to:

- Fixed vs. tactical asset allocation;
- Passive vs. actively managed portfolios;
- Suitable benchmarks;
- Degree of freedom to be given to active asset managers (tracking errors);
- Rebalancing policies and ranges; and
- Style bias i.e. value versus growth.

Throughout this process when the asset class strategy is being set, the intention should be to improve the risk-reward relationship of the overall strategy. For example, if one chooses active management over passive management, then such a decision should be on the basis that it will improve returns for similar risk (or minimal additional risk), or that actively-managed portfolios have reduced volatility.

Portfolio Structure

In this stage, one takes the roles defined by the asset class strategies and matches them to the names of the best available managers.

When combining managers one will need to assess the overall portfolio structure and the impact on risk of combining a number of different managers. To assist with this process, one can review overlap analysis, historical correlation between portfolios and a holistic style analysis.

Prevailing legislation compels the GF to use the PIC for this purpose.

Manager Selection

Similarly current legislation precludes Management from deciding which asset managers would be utilised to manage the Fund's assets. However, we have listed the issues that would have to be considered if this changed:



Management would look beyond performance in identifying and selecting appropriate investment managers. The epitome of manager selection is in identifying those managers who are most compatible with the Fund's investment strategy – NOT who is this year's star performer.

In order to identify suitable asset managers, Management will need to adopt a **multi-criteria scoring methodology**. This involves defining a set of selection criteria and assigning weightings of importance to each of these criteria. By scoring the managers' ability in terms of these selection criteria (and in line with the importance weightings assigned), management will have a more objective approach to manager selection.

Every selection process will assess the managers on a standard set of criteria, namely:

- **“Sleep well”** factors – this refers to qualitative issues such as philosophy, process, people, ownership, etc. These factors give Trustees peace of mind that the organisation is well established, stable and sustainable.
- **“Seems good”** factors – this refers to quantitative issues such as performance and risk analyses. Because these factors are typically based on historical data, they are not guarantees of future outcomes but rather serve to support the qualitative issues assessed – by looking for consistency between what the manager says and what he has done.

In addition, management may have stipulated other factors at the Governance stage of the process that must be incorporated in the manager selection process. For example, if empowerment was identified as a requirement of the Fund, then the empowerment capabilities of the managers must be a criterion in the manager selection process.

Having assessed managers in terms of these criteria, Management will be better able to understand the drivers of the managers' performance and will evaluate the performance in the correct context.

Security Selection

The core responsibility of the PIC will be to identify those securities (i.e. shares, bonds, cash instruments, etc) that will yield the required value to meet the Fund's objectives.

The task of security selection is generally delegated in full to the asset managers who then pick the appropriate securities in line with the investment mandate given to them by the Trustees, as well as in line with their stated philosophy and style, adequately research the companies and the equity sectors, in addition to evaluating the factors that influence market and economic conditions.

In addition to not having the sufficient time to spend on security selection, management do not have the necessary access to research or the required expertise to properly assess and invest in the most appropriate securities.

We have appended a draft Investment policy document in so that Management have an idea of final document that will be produced as a result of following the above procedure.



5. ADMINISTRATION SYSTEM

The administration section deals with two distinct sections as follows:

1. Source of Deposits
2. Ongoing administration

Source Deposits

In performing our review we studied the following legislation which impacts on the GF:

- Administration of Estates Act,
- Insolvency Act;
- Companies Act;
- Pension Funds Act;
- Children's Act;
- Medical Schemes Act;
- Expropriation Act.

A recurring theme throughout all the above legislation is that it places an obligation on the GF to receive monies from various sources, typically where these amounts are unclaimed.

In order to successfully administer the monies received into trust the GF must ensure the following steps are in place:

1. All possible sources of deposits must be identified;
2. For each identified source there must be an application procedure in order for the GF to receive the monies;
3. No monies should be accepted with the depositor adhering to the procedures laid down for acceptance of the monies.

We can illustrate this concept by way of example. The Pension Funds Second Amendment Act permits retirement funds to deposit with the GF any unclaimed surplus benefits. The GF should not accept these unclaimed surplus benefits unless the retirement fund furnishes the GF with the following supporting documentation:

1. Copy of the Surplus Apportionment Scheme;
2. Schedule of benefits pertaining to members which ties up to the deposit received. The schedule must contain the members name, date of birth, gender, company employed by and other relevant information which would assist in the verification of the member.



Ongoing Administration

The ongoing administrative requirements of the GF are not dissimilar to those of a retirement fund. The administration of retirement funds involves the receipt of contributions, maintenance of member/beneficiary records and payment of benefits to members/beneficiaries. To this end it is relevant to consider the developments in administrative technologies to assess where these can be applied to the GF.

Benefit administration today is done typically on either a daily priced system or monthly unitised system.

Daily Priced Administration

The administration system is fully integrated with the asset manager systems and member benefit records are updated daily with investment returns. The member records are essentially “live” with a one day backlog. Added to this is an integrated ledger that is automatically updated.

Monthly Unitised Administration

This method of administration involves the use of actuarial expertise in calculating monthly returns that are applied to members benefit records. Full accounting functionality is typically integrated into an administration system of this nature.

Regardless of the continuous improvement in the quality of administration and accounting systems, all funds will still experience a level of mismatching between the assets and liabilities of the Fund at any point in time. **This will be true of any administration system adopted by the GF.**

These mismatches will arise as a result of beneficiary records being updated at a certain point in time with the investment manager being allowed a period of 48 hours to update and invest the relevant monies (any market movement during this 48 hour period could lead to a mismatch). Other mismatches will arise as a result of estimates of investment fees (particularly where there are sliding scales, or performance based fees), expense provisions being out of line with the actual expenses, and bank interest earned on provisions, etc.

The GF however will always be subject to significant mis-matching as a result of the practice of the Minister declaring an interest rate in advance. This practice impedes management’s ability to test the solvency of the GF at any point in time.

Management will need to spend time in reviewing how this process of matching the assets and liabilities can be improved. Essentially this process should involve reviewing the assets and liabilities on a monthly basis, and where appropriate taking the necessary action to align the assets and liabilities.

The process should include monitoring certain transactions (those that are known to have a high probability of creating a mismatch, e.g. large transactions (mass payments to the PIC, delays at the investment managers) on a daily basis.



We now set out our key areas of concern in respect of the administration platforms utilised by the GF:

Issues

1. Manual record keeping at some sites;
2. No interface with the General Ledger;
3. Not able to provide age analysis of beneficiary records;
4. Cashbook is not maintained;
5. Beneficiary records' not updated automatically.

The administration of the funds in trust is one of the key responsibilities of Management in the current legislative environment. Management would therefore need to strategically position themselves to effectively deal with this requirement.

Strategic positioning would involve evaluating core competencies and making trade offs. The evaluation of core competencies will inform Management of the trade-offs that are required to be made. Many managers are lulled in the false belief that making trade offs are a sign of poor management or perceived weakness. Choosing a strategic position is as much about deciding which activities will be pursued by an organisation as deciding which activities will not be pursued.

Those activities in which Management exhibit the competencies must be selected and those where deficiencies exist must be outsourced. The activities that Management select must further be integrated into the organisation to form a value chain that is not easily interrupted.

Once the evaluation of competencies is complete Management would have the following options available:

Options

Outsource to Professional Administration Company

This option would require the “back office” functions to be outsourced to an organisation that has identified their core competency as administrative capability. The existing front office could be maintained with the GF retaining their contact with their stakeholders. This option allows mitigation of certain risks mentioned above.

In-house Software Development

This option involves the development of a program that caters for the specific requirements of the GF. This is the highest risk option as a very high percentage of software development projects fail (either completely or exceeding budget time).

Off the Shelf Package

The purchase of an off the shelf package is also available. Any package of this nature would require significant tailoring to meet the specific requirements of the GF. Annual licensing fees and maintenance make this option the least viable for consideration. This option could represent the highest upfront cost and considerable risk in implementation.



6. FINANCIAL MANAGEMENT

This section deals with weaknesses we identified in respect of the financial management of the GF. Again we list the issues and provide a number of practical options for consideration.

Solvency

We indicated in the section on administration how mismatches occur. Without proper intervention the solvency of the GF will be compromised. In our analysis we have further established that there have been no attempts to match beneficiary liabilities to assets held. In short, the level of solvency of the GF is unknown. There are a number of ways to address the issue. We have listed the broad steps as follows:

1. Determine the current solvency level
This step would require actuarial intervention in determining the total liabilities and matching those to assets held in trust. This function can be dealt with immediately and all that would be required from management is the appointment of a suitably qualified actuarial consulting firm.
2. Interest declared in Advance vs. Actual Returns
The current process of declaring an interest rate in advance aggravates the situation of maintaining solvency. When a predetermined rate of return is applied to the beneficiary records the records matched status is upset when different returns are actually achieved on the invested assets. The legislation must be amended to ensure that beneficiaries are credited with actual investment returns earned on the assets backing the liability. This would address the concern that NT benefits when investment returns exceed the interest rate declared.
3. Maintain the solvency level
Assuming the solvency level has been determined and the appropriate steps put in place to achieve a funding level of 100%, the next challenge would be to maintain and manage the solvency levels. As described in the section dealing with administration, the ongoing maintenance will be driven largely by the administration platform and supporting processes put in place. As a general rule, the more sophisticated the administration platform the less manual intervention would be required.

Issues

- The inability of management to assess the solvency of the GF

Options

- Management should appoint an actuary to assist in assessing the solvency levels of the GF.



Centralised Guardians Fund

Currently each Master maintains their own Guardians Fund. This has resulted in different levels of accounting and administration compliance with the objectives already in place.

In order to have a structured approach to managing assets of this magnitude the most optimal approach would be to centralise the administrative and accounting functions. The costs of activities that are common to all GF sites would be greater for a decentralised structure. For example, a large central accounting department in a centralised organisational structure may be less costly to operate than separate accounting departments for each site.

Budgeting and Planning

The various activities within the GF should be coordinated by the preparation of plans of action for future periods.

Our objective in this section is to focus on the planning process within the GF and to consider the role of budgeting within this process. What do we mean by planning?

“Planning is the design of a desired future and of effective ways of bringing it about”

We will be discussing strategic planning, which may be defined as a systematic and formalised process for purposely directing and controlling future operations towards desired objectives for periods extending beyond one year. Short-term planning or budgeting must accept the current environment and the resources presently available. We begin with the stages in the planning process:

1. Identifying objectives

Strategic planning requires the specifications of objectives towards which future operations should be directed. For planning purposes it is necessary that the GF's objectives specifically indicate the direction in which the resources of the GF should be pointed. We would suggest that the objectives answer a number of fundamental questions about the future growth and development.

The objectives would therefore establish and map out the direction in which management wishes to be heading. If possible the attainment of the objectives should be measurable in some way and ideally people should be motivated by them.

2. Identify potential strategies

The next stage is to identify a range of possible strategies that might enable the GF's objectives to be achieved. It will be necessary to undertake a strategic analysis to become better informed about the GF's present situation. This would involve the following:

- Analysing the environment in which the GF operates;
- Analysing the resources that the GF possesses (or has access to) in order to understand its strategic capability.

The formulation of the strategy is concerned with matching the capabilities of the GF with its environment. Analysing the nature of the environment is required in



order to understand the key variables affecting the performance and how well it is positioned in terms of those influences.

Besides matching its strategies to the environment the GF should only pursue strategies it is **capable of sustaining**. It is therefore vital that an analysis of the available resources is conducted to determine the extent of its capabilities.

Before selecting viable course of action management would undertake an analysis of their strengths and weaknesses to determine the areas in which they can positively contribute and those which will be outsourced. In particular management would assess the resources and skills required for each potential activity and which of those skills and resources are currently available or easily attainable.

Having undertaken a strategic analysis, the next stage is to identify alternative strategies. We would suggest the following approach:

- The generic strategy to be pursued (i.e. the basis on which the GF will proceed or a sustainable progression);
- The alternative directions which the GF may wish to develop;
- The alternative methods by which any development may be achieved.

Before considering the alternative development directions, the GF should determine the end goal or utopian situation. With the end in sight Management can take deliberate steps to achieve those pre-determined outcomes.

3. Evaluation of strategic options

The alternative strategies should be examined within the context of the strategic analysis to assess their relative merits. In particular, criteria should be established for judging the merits of particular strategies. Our recommended criteria would be as follows:

- **Suitability**, which seeks to ascertain the extent to which the proposed strategies fit the situation identified in the strategic analysis;
- **Feasibility**, which focuses on whether the strategy can be implemented with current resources;
- **Acceptability**, which is concerned with whether the proposals will be accepted by the various stakeholder i.e. National Treasury, SARS ect

The above represent a broad framework against which strategic options can be gauged. Management would be charged with selecting the strategies which have the greatest potential for achieving the GF's objectives.

4. Select course of action

When management have selected those strategic options, long-term plans should be created to implement those strategies. In particular, plans for administration platforms, remuneration structures, disaster recovery plans, GAAP compliance ect. These plans must be coordinated and translated into financial terms by projecting the financial consequences of current and future plans for several years. The resulting statement will be the GF's long-range financial plan. This financial plan



should highlight the long-range revenues, cash flow and balance sheet forecasts for future years.

5. Implementation of long term plans

Budgeting is concerned with the implementation of the approved program within the long-range plan and capital budget. Programs represent various activities such as developing communication strategies or investment policies. The budget translates the long-range plans into an annual operating plan.

6. Monitor actual outcomes

The final stage in the process is to compare the actual and planned outcomes and to respond to any divergences from the plan.

The reason for producing budgets are as follows:

- To aid the planning of annual operations.
- To coordinate the activities of the various parts of the GF and to ensure that the parts are in harmony with each other.
- To communicate plans to the various sites;
- To motivate managers to strive to achieve the GF's goals.
- To control activities.
- To evaluate the performance of managers.

Planning

The major planning decisions will already have been made as part of the long-term planning process. However, the annual budgeting process leads to the refinement of those plans, since managers must produce detailed plans for the implementation of the long-range plan. Without the annual budgeting process, the pressures of day-to-day operating problems may tempt managers not to plan for future operations. The budgeting process ensures that managers do plan for future operations, and that they consider how conditions in the next year might change and what steps they should take now to respond to these changed conditions. This process encourages managers to anticipate problems before they arise, and hasty decisions that are made on the spur of the moment, based on expediency rather than reasoned judgement, will be minimised.

Coordination

The budget serves as a vehicle through which the actions of the different parts of the GF can be brought together and reconciled into a common plan. Without any guidance, managers may each make their own decisions, believing that they are working in the best interests of the GF. It is the aim of budgeting to reconcile these differences for the good of the GF as a whole, rather than for the benefit of any individual area. Budgeting therefore compels managers to examine the relationship between their own operations and those of other departments, and, in the process, to identify and resolve conflicts.

It is most unlikely that the first draft of the budget will produce a perfect meshing of all the GF's activities. Such differences must be corrected before the final budget is agreed. A sound budgeting system helps to coordinate the separate organisational activities and ensures that all parts of the GF are in mutual harmony.



Communication

If the GF is to function effectively, there must be definite lines of communication so that all the parts will be kept fully informed of the plans and the policies, and constraints, to which the GF is expected to conform. Everyone in the organisation should have a clear understanding of the part they are expected to play in achieving the annual budget. This process will ensure that the appropriate individuals are made accountable for implementing the budget. Through the budget, Management communicates its expectations to lower level management, so that all members of the GF may understand these expectations and can coordinate their activities to attain them. It is not just the budget itself that facilitates communication – much vital information is communicated in the actual act of preparing it.

Control

A budget may assist managers in managing and controlling the activities for which they are responsible. By comparing the actual results with the budgeted amounts for different categories of expenses, managers can ascertain which costs do not conform to the original plan and thus require their attention. This process enables management to operate a system of management by exception, which means that a manager's attention and effort can be concentrated on significant deviations from the expected results. By investigating the reasons for the deviations, managers may be able to identify inefficiencies such as the late payment of amounts dues to beneficiaries, SARS etc. inefficiencies have been found, appropriate control action should be taken to remedy the situation.

Performance evaluation

A manager's performance is often evaluated by measuring his or her success in meeting the budgets. In some companies bonuses are awarded on the basis of an employee's ability to achieve the targets specified in the periodic budgets, or promotion may be partly dependent upon a manager's budget record. In addition, the manager may wish to evaluate his or her own performance. The budget thus provides a useful means of informing managers of how well they are performing in meeting targets that they have previously helped to set.

Issues

1. Current planning process does not ensure cohesive or congruent practises.

Options

2. Review current budgeting and strategic planning process.



7. EDUCATION/COMMUNICATION AND IMAGE

One of the key principles of King 2 was transparency. Similarly in the Myners Review, transparency was highlighted as a key issue. One of the best ways to achieve transparency is by ensuring clear, comprehensive, timeous communication.

Effective communication can go a long way to improving the public's perception of the Guardians Fund. Another key advantage would be to become the preferred destination for unclaimed benefits within the retirement funds industry.

It may seem unusual to list communication as a risk area, however, in general communication is an overall risk-mitigation strategy.

Even more important is that an environment of open, regular communication tends to lead to a feeling of a trust with the management of the fund, equally well non-existent communication will lead to distrust. In general, if communication is improved, it is far less likely there will be as many complaints from beneficiaries. This is important, since particularly where complaints are escalated significant costs can result even where the complaint is not upheld.

Our research has focused solely on the existing Guardian's Fund web site: www.doj.gov.za/master/guardian.html - in the absence of access to other materials, discussions or documents produced by the fund.

The materials reviewed via the website are:

1. A pamphlet produced in 2004/2005;
2. The Annual Report for the year ended 31 March 2003;
3. A set of questions and answers based on the pamphlet; and
4. An Application for monies from the Guardian's Fund (J251), Application for allowance or interest (J31).

After review of these documents, it is clear that there is a great deal that can be done immediately to improve communications available to interested parties:

1. The website information should be updated;
 - The website should be reviewed as part of a full marketing strategy, but a "quick-win" would be to revise the content within the existing structure and add new pdf's for downloading and printing where appropriate;
2. The pamphlet communication is simple, and could be improved on;
 - The pamphlet should provide more detail, in simpler language and rewritten to include bullet points, and structured to explain complex terms or concepts more clearly.
3. Q & A should have more detail;
 - The Q&A should also be simplified, with more detailed questions added to educate and explain more fully the operation of the Guardian's Fund.



4. No consistency with the branding;
 - There is some common use of photos in the printed materials but inconsistent use of the logo of the Master of the High Court, as well as the Department of Justice's coat of arms. These should be reviewed within the context of the guidelines specified by government for the use of the coat of arms, and the look and feel for future communications agreed specified in writing to avoid misuse.
5. We also need to establish how the printed materials are distributed and who receives them in order to establish whether the materials are reaching the desired recipients, and to take correctional action if not.

To implement an effective communication strategy, it will be necessary to begin by establishing much more detail with regard to these questions:

1. What is the objective of the communication?
2. Who must be communicated with?
3. Which communication channels are best used to communicate this message to its intended recipient?

It is important that all the marketing activities are coordinated and integrated to ensure that they all give out the same, consistent message, irrespective of the medium, and that cost efficiencies are maximised.

Proper research of the target market would need to be carried out and the results used to ensure that the communication strategy recommended will place the right communications in the hands of those it is intended to reach, and that it will be effective and understood.

Changing perceptions of the Guardian's Fund will require a two-part strategy – a public relations strategy and a trust and credibility will need to be built through the experience of those interacting with the Fund. This means that the administration and customer service experience of beneficiaries and other target publics be enhanced to generate goodwill, and positive word-of-mouth discussion.

A public relations campaign to launch the education efforts will likely be the best way to begin, and editorial and PR stories would be submitted to appropriate press to increase awareness and begin to change perceptions of the Fund. In support of these efforts, an advertising campaign could be launched to advertise the "New and improved" Fund, but would depend on the budget available.

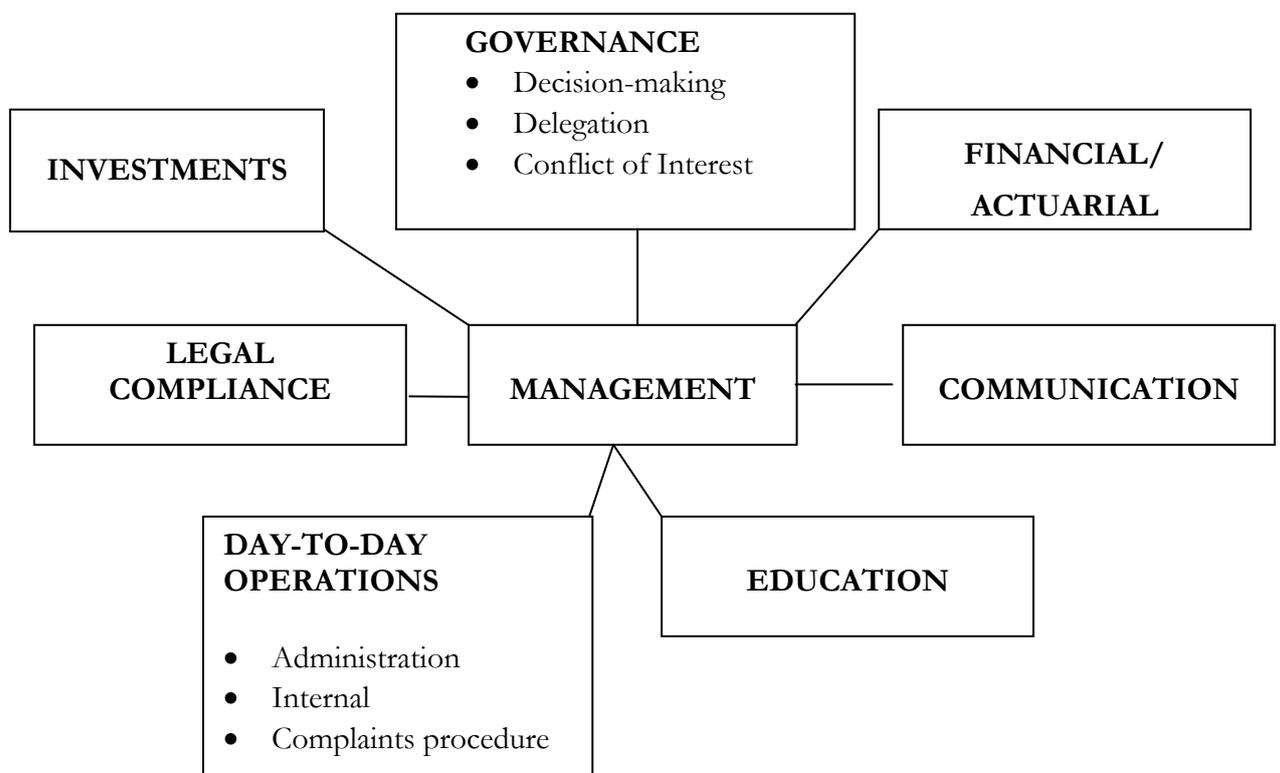


8. LIABILITY AND EXPOSURE

In determining where any liability would be housed we looked at the key risk areas. We then go on to set out the identified areas of liability within each area (where risk coupled with liability exist).

What are the key risk areas for the Guardians Fund?

There are so many risks facing the GF, the most manageable way to deal with them is to separate them into distinct risk areas. This is similar to the way a Board of directors will assign portfolios, or establish subcommittees for each key area. Our representation of the key risk areas is as follows:



These areas can be configured, or reordered. The most important issue is to put together a structure of management that makes sense.

To explain the areas highlighted in more detail:

- *Governance*

Under this headline, one will deal with issues such as:

- Decision-making;
- Delegation;
- Conflicts of interest;

Many of these principles will apply across the other risk areas.



- *Investments*

Investment risks are generally the easiest understood, and these risks will be dealt with in a separate document.

- *Legal Compliance*

These are the risks relating to rules, contracts, and legislative changes.

- *Financial / Actuarial*

These are the risks relating to the responsibilities in relation to financial statements, internal controls, administration, solvency, budgeting etc.

- *Communication*

This is a less obvious risk for Management, but effective communication will assist with potential problems that arise. This is particularly important when dealing with risks such as administration and investments that have a direct impact on beneficiaries.

- *Education*

This deals with the education requirements of Management. Clearly risks exist where Management have not had the opportunity to follow training courses to increase their skills.

- *(Day-to-Day) Operations*

This risk relates to the day-to-day operations. These issues relate to:

- administration of the Fund;
- offices of the Fund;
- method of dealing with complaints
- Payments to beneficiaries

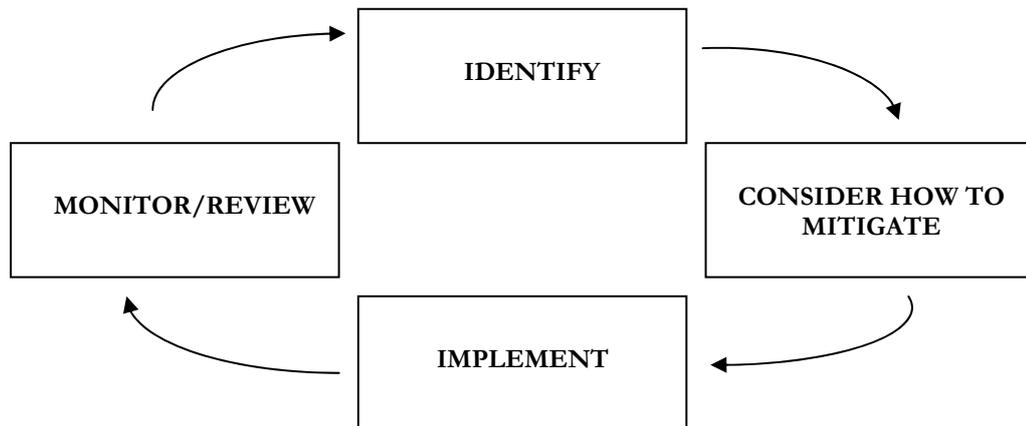
How does one practically address each of these risk areas?

For each risk area, management need to cover the following process:

- (a) identify what risks face the Board of Management/Fund;
- (b) consider how to mitigate such risks;
- (c) implement mitigation/risk management processes; and
- (d) monitor and review the success of the processes put in place



The risk control cycle can be graphically represented as follows:



As part of this process, Management again must consider the extent to which they, themselves will retain responsibility for components of each of the risk control cycles. The general approach, as set out previously was that Management will need to consider:

- their resources, primarily time; and
- their expertise.

Depending on the answer, Management must then either retain that function or delegate such function to a suitable expert.

Investments

The PIC invests monies held by or on behalf of the Government and the money in the Guardian's Fund is deemed to be a deposit for the purposes of the Public Investment Corporation Act. The Master can pay amounts that are due and payable out of a working balance which is retained for the Master's disposal.

The definition of "deposit" includes money received by any body, established by law (which would include the Guardian's Fund). The PIC has to develop an investment strategy to regulate the investment of deposits. Obviously this strategy would be mindful of the rate set by the Minister in the Gazette.

The PIC is a juristic person outside of the public service and established in terms of the Companies Act, to the extent that the provisions of the Companies Act are applicable to the PIC. The PIC Act or Minister can declare certain provisions of the Companies Act not applicable to the PIC.

Having perused the PIC Act, we can find no legislated liability, in that the PIC is not specifically held liable for losses incurred in respect of any investment held by the PIC.



The existing contracts with the PIC place the onus on the GF to determine/ provide the following (key responsibilities):

1. Research the appropriate asset allocations for the mandate;
2. Warrant that the said asset allocation meets all legal and regulatory requirements.
3. That appropriate asset/ liability modelling will be conducted.
4. That no laws have been breached in developing the investment mandate.
5. To formulate the investment strategy, objectives & guidelines.

Failure to adhere to the above would result in liability resting with Management of the GF.

Financial/ Administrative

It was confirmed that the DG in the DOJ is the accounting officer for the GF. The PFMA confers a large amount of responsibility and concomitant liability onto the accounting officer.

Section 86 of the PFMA, offences and penalties, lists the offences and applicable penalties as follows:-

A penalty which may include a fine or imprisonment not exceeding five years for contravention of the following sections:

S38: General Responsibilities of Accounting officer

S39: Budgetary Control: Responsibilities

S40: Reporting responsibilities

S50: Fiduciary duties of accounting authorities

S51: General responsibilities of Accounting authorities

S55: Annual report & financial statements

Various fidelity, errors and omissions insurance policies are available in the market which could go a long way to protect management from personal loss.

In addition a structured approach to the management of the GF will go along way to mitigating risks that arise.



9. CONCLUSION

The purpose of this draft discussion document is to rule out the areas where our recommendations are either not acceptable (as a result of different strategic views by policy makers) or desirable as a result of management selecting an alternative solution.

The document will then be tailored into presentable recommendations which can be submitted to the various stakeholders for consideration.

Your detailed comments are therefore requested.

